No. 88-396

Supreme Court, U.S.
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In the Supreme Court of the United States

OCTOBER TERM, 1988

COLONIAL AMERICAN LIFE INSURANCE COMPANY,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether "ceding commissions" payable by a reinsurer to the initial insurer as consideration for the right to share in the future income stream from a block of life insurance policies reinsured under contracts of indemnity reinsurance are fully deductible in the year paid, or, instead, whether such payments must be capitalized and amortized over the estimated life of the reinsurance agreements.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-9a) is reported at 843 F.2d 201. The opinion of the Tax Court (Pet. App. 11a-22a) is unofficially reported at 51 T.C.M. (CCH) 1123.

JURISDICTION

The judgment of the court of appeals was entered on April 26, 1988. A petition for rehearing was denied on May 25, 1988 (Pet. App. 23a). The petition for a writ of certiorari was filed on August 22, 1988. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner is a Louisiana corporation engaged in the business of writing and reinsuring life, accident, and health

insurance contracts. During the years at issue, it qualified for federal income taxation as a "life insurance company" under Section 801 of the Internal Revenue Code.[1] In 1975 and 1976, petitioner entered into four indemnity reinsurance agreements with respect to a block of life insurance policies written by Transport Life Insurance Company. In these agreements, petitioner agreed to reinsure the aggregate total of 76.6% of Transport's liabilities under that block of policies by indemnifying Transport for that portion of its losses.[2] Some of the reinsurance was accomplished by means of conventional coinsurance agreements and the bulk of the reinsurance was accomplished by means of modified coinsurance agreements.[3] In addition, petitioner became entitled to 76.6% of the future premiums (less expenses) received on the policies. Pet. App. 2a, 4a-5a.

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[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect in 1975 and 1976, the years at issue (the Code).

[2] In indemnity reinsurance of the types involved here, the initial insurer and the reinsurer agree to share the premiums, expenses, and liabilities on a block of existing policies. The reinsurer in "indemnity reinsurance" does not become directly liable to policyholders, but agrees only to indemnify the initial insurer for its losses; the initial insurer continues to receive premiums and to pay expenses and benefits to the policyholders. This method of reinsurance contrasts with "assumption reinsurance," in which the reinsurer, in effect, steps into the shoes of the issuing company with respect to the policies, becoming directly liable to the policyholders and directly entitled to premium payments made by them. See generally Pet. App. 2a-4a; *Modern American Life Ins. Co.* v. *Commissioner*, 830 F.2d 110, 110 n.2 (8th Cir. 1987).

[3] Under the "conventional coinsurance" agreements that covered 6.6% of the liabilities, petitioner established its own reserves to cover the reinsured liability and Transport reduced its reserves accordingly. Under the "modified coinsurance" agreements, covering 70% of the liabilities, Transport maintained the required reserves and was required to collect and pay over to petitioner the investment income derived from the assets supporting the reserves.

The agreements provided that Transport was to pay petitioner, as reinsurance premiums, amounts equal to the reserves required to be established by petitioner to cover the conventional coinsurance liability for this block of policies.[4] These reinsurance premiums were $675,762 for 1975, and $851,398 for 1976. The agreements further provided that petitioner was to pay "ceding commissions" to Transport, in consideration for the business acquired, of $680,000 for 1975 and $852,000 for 1976. These offsetting obligations were netted against each other prior to payment, with the result that petitioner paid Transport $4,238 in 1975 and $602 in 1976. In addition, petitioner paid Transport a finder's fee of $13,600 in 1975. Pet. App. 4a-5a.

Petitioner sought to deduct the full amount of the "ceding commissions," as well as the finder's fee, in the years of payment. Thus, petitioner reported tax losses of $693,600 for 1975 and $852,000 for 1976 as a result of the reinsurance transactions, although those transactions presumably had been entered into by petitioner with the

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[4] The reinsurance premiums provided for in the agreements covered only the conventional coinsurance agreements; Transport retained all assets corresponding to the reserve liabilities reinsured under the modified coinsurance agreements, which covered 70% of Transport's rights and liabilities on those policies. The parties, however, elected to have these transactions treated for tax purposes as if they were conventional coinsurance agreements (see Section 820 of the Code), and therefore petitioner was treated for tax purposes as having received reinsurance premiums under those agreements also, in the amount of the reserve liabilities attributable to the reinsured risks. See Pet. App. 6a.

expectation that they would be profitable.[5] The Commissioner disallowed the deductions claimed for the ceding commissions and finder's fee. The Commissioner determined that these amounts represented the acquisition costs for economic benefits having a useful life beyond the year of payment – namely, the right to petitioner's share of the future income stream paid on the reinsured policies. Accordingly, the Commissioner reasoned that the ceding commissions should be capitalized and amortized over the period of indemnification (which was stipulated to be seven years (Pet. App. 9a n.6)). *Id.* at 2a, 6a.

2. Petitioner filed a petition in the Tax Court seeking redetermination of the resulting deficiencies, and the Tax Court ruled in its favor (Pet. App. 11a-22a). Relying on its prior decision in *Beneficial Life Ins. Co.* v. *Commissioner*, 79 T.C. 627 (1982), the court held that ceding commissions paid to the initial insurer in an indemnity reinsurance transaction may be deducted in full in the year of payment (Pet. App. 16a-22a). The court explained that an indemnity reinsurance transaction is not treated as a sale of assets, but rather as the initial insurer's purchase of insurance from the reinsuring company. Under that view, the court reasoned, the ceding commissions were deductible from petitioner's income as "return premiums [or] * * * other consideration arising out of reinsurance ceded" under Section 809(c)(1) of the Code. Pet. App. 17a-18a. The Tax Court acknowledged that ceding commissions paid in connection with an assumption reinsurance transaction would have to be capitalized and amortized over the estimated

[5] The other aspects of the reinsurance transactions generated no taxable gain or loss to petitioner. The reinsurance premiums received by petitioner from Transport were reported as income, but those amounts were exactly offset by deductions allowed for the concomitant increase in petitioner's reserve liabilities for the reinsured policies. Pet. App. 6a.

life of the policies involved, but it justified this disparity as being required by the Code itself on the ground that the Code "treats an assumption reinsurance transaction as a sale by the initial insurer to the reinsuring company" (*id.* at 17a).

3. The court of appeals reversed (Pet. App. 1a-9a). Agreeing with the Eighth Circuit's decisions in *Modern American Life Ins. Co.* v. *Commissioner*, 830 F.2d 110 (1987), and *Prairie States Life Ins. Co.* v. *United States*, 828 F.2d 1222 (1987), the court held that the ceding commissions reflected the acquisition costs of the intangible rights acquired by petitioner under the indemnity reinsurance agreements, and therefore were not fully deductible in the year of payment. The court recited the "fundamental rule that an amount expended to acquire an asset or economic interest, benefit or advantage with an income producing life extending substantially beyond the current taxable year may not be [expensed] in the year of payment but must be depreciated or amortized over its useful life" (Pet. App. 7a-8a), and it held that application of that rule here required that the ceding commissions be amortized over the estimated life of the reinsurance agreements. Quoting from its earlier decision in *Southwestern Life Ins. Co.* v. *United States*, 560 F.2d 627, 640-641 (5th Cir. 1977), cert. denied, 435 U.S. 995 (1978), the court of appeals specifically rejected the Tax Court's view that indemnity reinsurance should be accorded treatment different from assumption reinsurance on the ground that the latter is somewhat more analogous to the issuance of new insurance (Pet. App. 9a). Rather, the court concluded that the Code treats assumption reinsurance agreements the same as indemnity reinsurance agreements with respect to the deductibility of ceding commissions (*ibid.*).[6]

[6] The court of appeals also held that the $13,600 finder's fee must be amortized over the life of the policies (Pet. App. 9a). The Tax

DISCUSSION

1. The court of appeals correctly held that ceding commissions paid pursuant to indemnity reinsurance agreements represent the acquisition costs of intangible assets—namely, the reinsurer's share of the future income stream generated by the reinsured policies—and therefore must be capitalized and amortized over the indemnification period. Section 809(c)(1) of the Code, in allowing the deduction of "return premiums * * * and other consideration arising out of reinsurance ceded," was designed to ascertain true premium income by allowing appropriate adjustments for premium receipts that ultimately are not retained by the company receiving them. Thus, it would permit the initial insurer to deduct from its gross income premiums paid to a reinsurer to obtain indemnity reinsurance.

But no such adjustment is appropriate here. Contrary to petitioner and the Tax Court, Section 809(c)(1) should not be read to permit the immediate deduction of payments like ceding commissions paid by a reinsurer, which are inherently capital in nature. Permitting such a deduction would result in a gross distortion of income by mismatching the future income to be derived by a reinsurer from the reinsured policies with the current costs incurred to acquire the rights to that income. There is no reason to believe that Congress intended to permit insurance companies to distort their income in this way, which would constitute a drastic departure from the basic tax principles applicable to all other taxpayers who make current expenditures for future benefits. Nor is there reason to believe that Congress

Court had upheld the immediate deduction of the finder's fee, mistakenly stating that the Commissioner had conceded that the finder's fee should be currently deductible if the ceding commissions were held to be currently deductible (*id.* at 22a).

intended to establish such radically different tax consequences for indemnity reinsurers from those of assumption reinsurers, who are similarly situated for tax purposes in that each pays ceding commissions to obtain essentially the same rights to participate in the anticipated future income stream from the reinsured policies. Thus, we believe that the court of appeals correctly rejected petitioner's contentions. Because there exists a conflict in the circuits on this issue and because of its importance to the uniform taxation of a major industry, however, we do not oppose the petition for certiorari.[7]

2. Petitioner correctly states that the decision below and the Eighth Circuit's decisions in *Modern American Life Ins. Co.* v. *Commissioner*, 830 F.2d 110 (1987), and *Prairie States Life Ins. Co.* v. *United States*, 828 F.2d 1222 (1987), directly conflict with the Seventh Circuit's recent decision in *Merit Life Ins. Co.* v. *Commissioner*, 853 F.2d 1435 (1988). In *Merit Life*, the court of appeals agreed

[7] The provisions of the Code pertaining to the taxation of life insurance companies were substantially revised by Section 211 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 720. The question presented here, however, was not addressed by Congress and does not appear to have been affected by the revision. Section 809(c)(1) is carried forward in the revised provisions in substantially the same form in Section 803(a)(1) and (b) of the amended Code, which applies to tax years beginning after December 31, 1983. The revision did change the language of the provision somewhat, replacing the phrase "reinsurance ceded" with the phrase "indemnity reinsurance." But there is no indication that this substitution was intended to effect any substantive change, and the revision does not answer the question presented here—whether an immediate deduction is permitted for ceding commissions paid by a reinsurer in connection with indemnity reinsurance. Thus, the question presented here, although litigated in the context of a statutory provision that has been revised, Section 809(c)(1), has continuing significance for future years under the current version of the Code.

with the Tax Court that the Code provides for radically different tax treatment of indemnity reinsurance transactions from that of assumption reinsurance transactions. The court found that, in the case of assumption reinsurance, the ceding commissions paid by the reinsuring company could be analogized to commissions paid to agents upon the issuance of a new insurance policy, and it concluded that Congress intended in Section 809(c)(1) to permit the current deduction of such ceding commissions. 853 F.2d at 1438-1439, 1442. The Seventh Circuit expressly noted that its decision could not be squared with the decision below and with the relevant Eighth Circuit decisions, which it characterized as "misunderstanding and misinterpret[ing] the Code" (*id.* at 1441).

We agree with petitioner that it is appropriate for this Court to grant certiorari here to resolve this conflict in the circuits. If the conflict is allowed to persist, insurance companies entering into indemnity reinsurance agreements will receive disparate tax treatment depending upon the circuit in which their case is litigated. The insurance industry reports that indemnity reinsurance agreements constitute a major portion of its business. It is estimated that $440 billion of life insurance was reinsured in 1987 alone, with a total of $1.78 trillion of reinsured life insurance outstanding at the end of that year. Because the general practice in the industry would suggest that most of that reinsurance is indemnity reinsurance, it is apparent that the tax treatment of ceding commissions paid in connection with indemnity reinsurance transactions is an issue of considerable monetary significance. See generally Brief for the American Council of Life Insurance and the National Association of Life Companies as Amici Curiae at 7. Moreover, the number of these transactions and the

volume of recent litigation on this issue[8] suggest that the lower courts will continue to struggle with the correct tax treatment of indemnity reinsurance transactions unless the conflict is resolved. Accordingly, the interest of achieving uniform treatment of similarly situated taxpayers and considerations of administrative convenience and judicial economy suggest that this Court should grant certiorari to resolve the conflict in the circuits.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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[8] In addition to the cases cited, the question presented here is currently pending on appeal in *Oxford Life Ins. Co.* v. *United States*, No. 88-2295 (9th Cir.), a case that had previously been the subject of an appellate decision on a related issue involving the treatment of assumption reinsurance (see *Oxford Life Ins. Co.* v. *United States*, 790 F.2d 1370 (9th Cir. 1986)).

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